Offsets Revisited

By

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[The views presented below are those of the author and do not necessarily represent those of the United States government, the Department of Defense, the United States Air Force, or any of their agencies.]

> Competitiveness is the degree to which a nation can, under free market conditions, produce goods and services that meet the test of international markets while simultaneously maintaining or expanding real incomes of its citizens.
> "Global Competition," *The Report of the President's Commission on Industrial Competitiveness*, January 1985.

INTRODUCTION

Offsets are an increasingly controversial subject in international trade. The Spring, 1988 issue of *The DISAM Journal* contained a report by the Office of Management and Budget (OMB) which reviewed the 1987 direct commercial sale of Boeing AWACS (Airborne Warning and Control System) aircraft to the United Kingdom and France.[8] The OMB study represented an essentially neutral perspective regarding the major offset sales requirements associated with these transactions. A more positive view of the offset features of these sales is presented in the article by Boeing Spokesman R. Lee Hessler in this issue of *The DISAM Journal.* Also, the Summer 1988 issue of *The DISAM Journal* reported testimony presented by the American League for Exports and Security Assistance (ALESA) before Congress in which the offset issue was seen as generally harmless to U.S. industry and labor.[11] Finally, in December 1987, the OMB published a report summarizing three years of offsets which again reflected a generally neutral attitude.[7] A much different view will be presented in the discussion which follows.

This article is divided into four parts: Part I comments on the OMB article, and Part II discusses the ALESA testimony. Part III reviews the OMB summary of three years of offsets, and Part IV provides concluding observations. The subject of offsets is complex, and when placed within the context of overall international trade, it becomes even more complicated. However, these complexities may be simplified by focusing attention on the essentials. With respect to offsets, the essentials include the defense capabilities of the respective nations, technology transfer, industry and jobs, the military, and overall balances of trade.

PART I - OFFSET AGREEMENTS - THE AWACS CASE

In its review of the recent AWACS sale to the United Kingdom and France, the OMB took a neutral approach, in a sense reflecting a wait and see attitude. While reviewing the facts, important questions were only hinted at rather than dealt with in depth. This article will deal with some of those questions in greater detail.

The OMB noted:

> The stated purpose of the British offset program is to "facilitate the development of 'high technology' in the U.K. defense and aerospace industry and to stimulate imaginative projects for venturing and contracting. This involves the placing of work

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for high technology defense and aerospace production in the U.K. " The overall aim is to make British firms "competitive in the U.S. and other markets . . . ."

Although the offset package does not contain a commitment to provide jobs, it was touted by Boeing during the AWACs sales campaign as able to provide 50,000 man-years of work in Britain over the eight-year offset period.

The recent sales of AWACS to the United Kingdom and France involved guarantees of 130 percent offsets for each country. The OMB concluded, "However, the full implications of such high levels of offsets on U.S. competitiveness are as yet undetermined." Dealing only with defense, it may be possible to reserve judgement. However, when offsets are placed into the context of overall international trade, the results are less problematic.

Among the issues raised by OMB are (a) the size of the offsets, (b) fallout on other buys, (c) trade management, (d) technology transfer, (e) the civilian vs. military balance of trade, (f) wartime risks, (g) industry and jobs--access to markets, and (h) impact on the U.S. deficit. The effect of offsets and offshore purchases on the defense posture of the free world in general and the United States in particular, was not addressed. Neither was the leakage of technology to unfriendly powers and the added wartime risks. Many of these items are related, but herein will be dealt with individually. The last item, impact on the U.S. deficit, will be covered in Part III.

The Size of the Offset Agreement

Governments ordinarily require offsets for one or more reasons. They feel that they will gain jobs, advance their technology with an ultimately more competitive industry, and improve their balance of trade. Presumably, if the British and French gain these advantages, the U.S. will lose them. If the size of the offset measures the overseas gain, it also measures the American loss. This was the largest offset ever accepted by Boeing. The British first won the 130 percent offset, and the French then demanded and got the same.

There is no intention here to fault any of the parties involved. Boeing was operating under existing U.S. rules of trade. However, the Office of the U.S. Trade Representative considers offset sales to be in violation of the General Agreement on Tariffs and Trade (GATT).[9] The real issues are: (a) should the U.S. change the rules of trade with respect to offsets and the offshore purchase of defense goods? (b) And how do these relate to the overall U.S. trade situation?

Fallout on other buys

Individual U.S. corporations are clearly not capable of attending to American interests where offsets are involved. When corporations negotiate with foreign governments, the foreign governments generally set the terms. If such offsets do not support American interests, only the federal government can stop them or deal on equal terms. The first result of the 130 percent offset taken by the British, was that the French demanded and got a similar offset. The effect on future sales remains to be seen. The question now is, how open is Pandora's box?

Trade Management

Offsets are a form of trade management. Since World War II the U.S., has been a leading advocate of free trade. Under the theory of free trade all trading nations should be better off from free trade. Unfortunately, free trade can at best remain a theory. International trade has always been managed, either directly or indirectly. Direct forms of trade management include tariffs, quotas, export zones, offsets, and the value added tax (VAT). Indirect forms of management include the control of currency exchange rates, and fiscal and monetary policy. Since every nation manages these factors, the management of all international trade is a fact of life.

Direct forms of trade management are officially to be avoided in the name of free trade. Indirect means, though more subtle and slower, may also have significant impacts. Thus, the issue in international trade is not whether we should have trade management, but how it should be managed. Under free trade, wealth measured in goods is the only measure of success. Unfortunately, this is monochrome vision. Industry and jobs have a value in themselves. The British and French understand this very well. The 130 percent offset is their openly stated and very real acknowledgment that these values exist. The American economic community is only now awakening to these facts.[1,4]

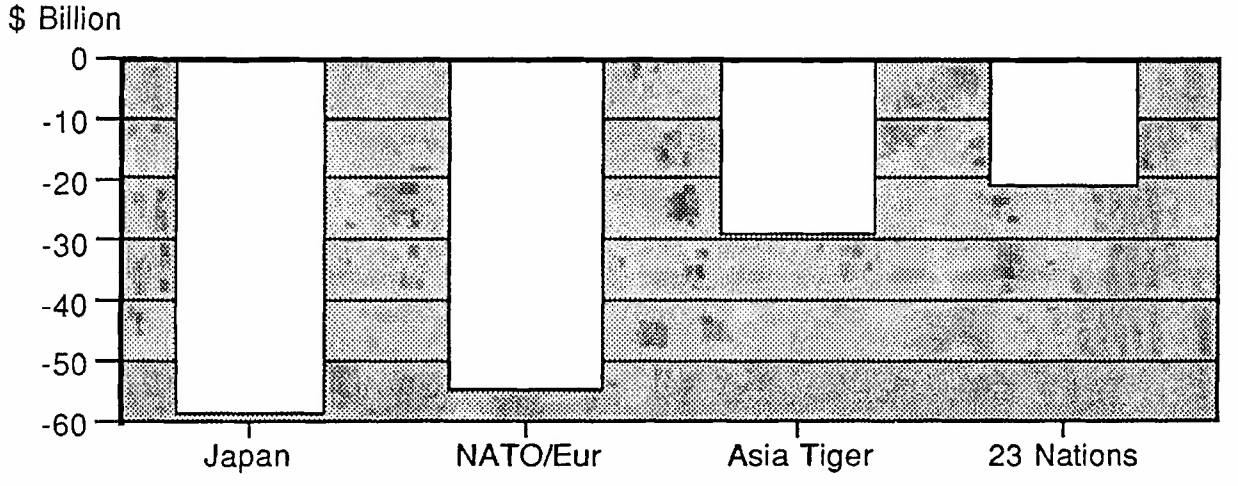
Technology Transfer:

There are values to trade other than maximizing the availability of inexpensive goods. In this context, the Franco-British requirements that not only must the offset be larger, but that substantial portions must be in high technology areas, makes sense. Both governments openly state that the purpose is to acquire the technology to enhance the competitive position of their industry, both civilian and military. This raises two issues: (a) the expanded vulnerability of the technology to unfriendly access, and (b) the potential damage to the American civilian economy.

The affair of Toshiba/Kongsberg is a recent reminder of the fact that the more people who know a secret, the more likely it is to leak out. To spread this very valuable technology for a relatively small immediate profit, is rather shortsighted. The leakage within the United States is bad enough, but to deliberately expand the risk is fool hardy.

With regard to civilian industry, advocates of free trade have long supported the idea that the United States should permit the loss of low tech industry to low labor rate nations, and concentrate on high tech where the U.S. presumably has an advantage. However, if "low tech" is deliberately abandoned and "high tech" is traded away, the U.S. is left with scraps. A great nation such as the United States needs every industry.

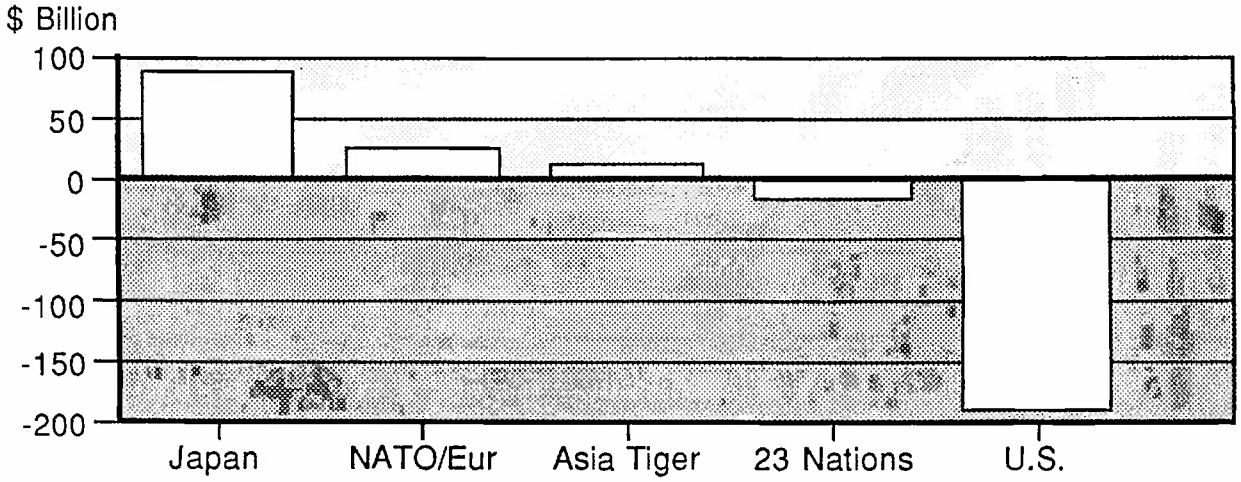
FIGURE 1
U.S. Trade Balances - 1986



Military and Civilian Balance of Trade

The U.S. trade deficit has reached damaging proportions. The effect is now being felt both in the defense and civilian industries. Figure 1 illustrates the U.S. 1986 deficit with its 40 major trading partners in groups. Figure 2 reflects the world trade balances of these same nations. The U.S. cumulative (1980-1986) deficit is with every major trading nation except Australia, Belgium, Israel, Spain, and Turkey. This includes both high and low tech nations, varying from Japan and Canada to India and Indonesia. Clearly, current trading policies are not in America's interest. Examining details of the figures in Table 1 (on the following page) we might conclude that the U.S. is the least efficient, least competitive nation on earth. However, such a result appears unreasonable.

FIGURE 2
World Trade Balances - 1986



If this result is rejected, then the conclusion must be reached that the trade situation is not simply a matter of industrial efficiency, but that other forces are at work. Competitivity is a much abused term. It has been shown that there are at least four definitions of industrial efficiency, of which two relate to productivity and two to competitivity.[2] Unless nations are compared using uniform definitions, the results are meaningless.

The previous military balance of trade has been favorable to the U.S. at the 10:1 level, but it has been steadily declining, and in 1986 it was 1.76:1. By permitting 130 percent offsets, a bad situation is made worse. At the same time, the British situation has improved, bringing it closer to a balance with the United States. France already has both a military and civilian trade surplus with the U.S.

> According to Jacque Benichon, the former president of the French industry association which was involved in deriving the offset agreement, the French aerospace industry currently sells the U.S. ten times more defense related goods than the U.S. sells to France. U.S. Defense Department data for fiscal year 1986, however, indicates the ratio of French-U.S. bilateral defense trade favors France 4:1 in terms of dollar value.[7]

The U.S. balance of trade, already incredibly bad, is worsened by offsets. Since aircraft represent one of the few industries in which the U.S. enjoys a trade surplus, it seems self-destructive to give away the advantage through offsets. Private corporations, however, cannot be

faulted. Only Congress and the Executive Branch can deal with the overall deficit. In conjunction with DOD, the issue of offsets must be addressed.

TABLE 1
United States and World Trade Balances (1986)
(millions dollars)

	Imports from U.S. (1)	Exports to U.S. (2)	U.S. surplus (deficit) (3)	percent export import (4)	percent U.S. deficit (5)	Exports to World (6)	Imports from World (7)	Surplus (Deficit) with (8) World	Percent Export/ Import (9)
	United States Balances					World Balances			
1. U. S.						222,707	406,070	(183,363)	55
2 Japan	26,882	85,457	(58,575)	318	-31.94	210,757	127,533	83,224	165
3 Canada	45,333	68,662	(23,329)	151	-12.72	89,706	85,686	4,020	105
4 Germany	10,561	26,128	(15,567)	247	-8.49	243,315	191,068	52,247	127
5 Italy	4,843	11,312	(6,469)	234	-3.53	97,827	99,925	(2,098)	98
6 U. K.	11,418	16,033	(4,615)	140	-2.52	107,088	126,326	(19,238)	85
7 France	7,216	10,586	(3,370)	147	-1.84	124,946	129,399	(4,453)	97
8 Sweden	1,871	4,637	(2,766)	248	-1.51	37,315	32,228	5,087	116
9 Switzerland	2,977	5,367	(2,367)	180	-1.30	37,456	41,049	(3,593)	91
10 Denmark	758	1,869	(1,111)	247	-0.61	21,158	22,844	(1,686)	93
11 Spain	2,615	2,956	(341)	113	-0.19	27,206	35,056	(7,850)	78
12 Norway	937	1,170	(233)	125	-0.13	18,261	20,289	(2,028)	90
13 Bel-Lux	5.399	4,191	1,208	78	.66	68.819	68,624	195	100
14 Netherlands	7,848	4,363	3,485	56	1.90	80,550	75,738	4,812	106
SUB-TOTALS	101,776	157,274	(55,498)	155	-30.27	953,647	928,232	25,415	103
15 Hong Kong	3,030	9,474	(6,444)	313	-3.51	35,420	35,360	60	100
16 Taiwan	5,416	18,995	(13,579)	351	-7.41	39,789	24,165	15,624	165
17 Korea	6,355	13,497	(7,142)	212	-3.19	35,624	33,35	2,289	107
18 Singapore	3,380	4,884	(1,504)	144	-0.82	22,490	25,506	(3,016)	88
SUB-TOTALS	18,181	46,850	(28,669)	258	-15.64	133,323	118,366	14,957	113
23 Other	51,840	73,158	21,318	141	-11.63	295,869	313.131	(17,262)	94
TOTALS	198,679	363,739	(164,060)	183	-89,47	1,593,596	1,487,262	106,334	(excl U.S.)

Wartime Risks

Just as serious as the damage to the civilian economy is the risk confronting the Western alliance as a result of the integration of their economies. During World War II, the near destruction of Great Britain due to German submarines, and the mostly unheralded total destruction of Japanese merchantmen, primarily by American submarines, provides a lesson we should not have to relearn. At that time the U.S. was almost independent with regard to imports and had a large available unused industrial capacity as a result of the depression.

Because of the current trade situation, not only have the industries moved overseas, but the very factories have been dismantled, placing the United States and the free world at high risk. Though the U.S. insists that a capability to manufacture all defense materials be maintained in the U.S. or Canada, this does not address the issue of quantities of other goods needed to support a general war. Sufficient auto, steel, shoe, and much other industrial capacity capable of being converted to wartime use, simply no longer exists. In case of war, the U.S. would be faced not only with shipping huge quantities of goods and men overseas, but also with importing goods as well. The disruption that would ensue, when aircraft carrying electronic components for missiles, avionics, and gunsights are shot down, or ships carrying steel are sunk, leaves little to the

imagination. Instead of being vulnerable on the outbound shipments only, the U.S. would be vulnerable on inbound shipments as well.

The policy of maintaining an independent military industrial base in the United States and Canada makes sense. Moreover, the question of maintaining the availability of an existing civilian component capable of being converted to a war effort, should not be overlooked.

Industry and Jobs

There are two primary reasons that offsets are desired: (1) industry and (2) jobs. The British clearly stated that their objective in the AWACS offset sales package is not just industry but high tech industry.

Boeing reported that the British should get 50,000 man years of work--presumably high tech work--from the AWACS sale. With the 30 percent surplus in the offset, we might expect the net gain in the U.K. to be 11,538 man-years. If 100 percent of the work for the AWACS itself were placed in the U.S., approximately 38,462 man years would be placed in the U.S., all of which would be later compensated (lost to the U.S.) along with the 11,538 man year gain by the U.K.

PART II - COMMENTS ON THE ALESA TESTIMONY

Smoke and Mirrors

The suggestion by ALESA that reporting requirements on offsets need not be increased is disingenuous. It may be true that there are some aspects of "smoke and mirrors" in offsets, and that the nations requiring them wish to appear as successful as possible to soothe the local politicians. Further, there may be a bit of exaggeration to the claims and to the performance. However, it is also possible that there is fire under the smoke. Without proper reporting, there is no way to determine the facts and ultimately to make proper decisions. Is the situation mostly smoke and mirrors covering a sham, or is it smoke signaling a giveaway "fire"? Only with proper reporting is it possible to tell.

Business with Offsets or No Business at All

The suggestion by ALESA is incorrect in asserting that the only options available to a firm involve either accepting offsets in order to do business, or rejecting offsets and losing business. A third option is business without offsets, and a fourth is the selection of offsets in a way which better meets defense interests. If American negotiators are known as "cream puffs," the U.S. will be hit often and hard. Only by retaining a hard bargaining position can Uncle Sam keep from being Uncle Sucker.

If the U.S. refused all offsets, many sales might be consummated without them, because it would be known that it was useless to attempt them. In the case of the AWACS sale, the British were faced with buying a better American system. They may very well have bought the American system without offsets, had the policy been not to award them.

The fourth alternative--the more selective use of offsets--perhaps makes better sense. The purpose of offsets is to gain industry and jobs. With the current U.S. trade situation, the rule with respect to offsets might be to permit them only with nations with which the U.S. is in trade surplus on a running five year average. (Such averaging would help smooth out yearly fluctuations.) No offsets for Japan, Canada, West Germany, etc, would currently be permitted under this rule, but they would be allowed with Australia, Belgium, Egypt, Israel, the Netherlands, Spain, and Turkey. Nations with ongoing trade surpluses with the U.S. have no legitimate reason to ask for offsets from the U.S.

The argument that the free world will be weaker when Great Britain, France, and others refuse to buy American arms has some legitimacy. However, the onus must fall on them. They must bear the responsibility for such weakening. The U.S. cannot be intimidated each time another nation threatens actions which weaken the free world.

Hard Currency Shortages

> *Purchasing foreign goods generally requires use of a hard currency. For countries facing severe shortages of currencies, counter trade may be used as a way to generate such currency to offset the original outlay.*
>
> ALESA Testimony.

There are some nations which, despite their surpluses with the U.S., still have foreign currency shortages, but to which we would still like to sell U.S. weapons. However, examining Table 1, we note that almost every trading nation has a trade surplus with the U.S. The United States is more than doing its share toward helping most currency short nations earn dollars. Those with surpluses in the U.S. can use the dollars already being earned here to buy the required weapons. If they have overall deficits, they should address the deficit issues with the surplus nations. The U.S. should politely explain that we expect their weapons purchases to be made here, using their surpluses with the United States in the United States.

Exchange Rates

> *The foreign exchange rate problem is further complicated by overvalued exchange rates in the Third World, which makes the prices of the developing country's goods unattractive on the open markets. Counter trade offers the customer a de facto way to discount the real prices of those goods while avoiding the politically sensitive step of devaluation.*
>
> ALESA Testimony.

The question of overvalued exchange rates might better be addressed to the U.S. Despite significant drops in the value of the dollar, it is still overvalued as measured by the trade balances. If the dollar dropped by another 15-30 percent against Western European and Japanese currencies, and 25-50 percent against Canadian, Taiwanese, Korean, Singaporan, and Hong Kong currencies, U.S. trade would rapidly come into balance. All U.S. goods would become an attractive bargain in the world. Meanwhile, the issue should be rejected as an item for trade negotiations. Rather, the policy of yielding offsets only to nations with five year average trade deficits with the U.S. should be pursued.

Exports Equal Imports

> *Anytime there is an export, somewhere, at sometime, from someplace, there is an import . . . What countertrade does is to close that loop in a much more dramatic fashion.*
>
> ALESA Testimony.

This comment implies that despite the advantageous offsets to the U.K., France, and others, because all trade must eventually come into balance, sometime, someplace, somehow, the U.S. will gain a counterbalancing sale. Unfortunately, with the U.S. balance of trade running at about $170 billion per year, some balancing sale at some indefinite time in the future is no longer

satisfactory. The trade crisis exists now. It is important that the U.S. use those areas where it can, to best advantage.

Burden Sharing

The failure of most of our allies to carry their share of the defense burden is now notorious. In the next section a means of dealing with this issue will be described.

PART III - COMMENTS ON THE OMB THREE-YEAR SUMMARY

Competitiveness

In its Three Year Summary, OMB continues its mixed opinion of offsets.[7] The authors quote the definition of competitiveness given by the President's Commission on Industrial Competitiveness which introduces this article, and they also quote DOD policy, as follows:

> Because of the inherent difficulties in negotiating and implementing compensatory coproduction and offset agreements and the economic inefficiencies they often entail, DOD shall not normally enter into such agreements. An exception will be made only when there is no feasible alternative to ensure the successful completion of transactions considered to be of significant importance to the United States national security interest (e.g., rationalization of mutual defense arrangements).

In the face of these comments, the OMB relates how offsets are a fact of life in military sales and that trade management rather than open competition is the norm. The OMB's comments are in a sense an attempt to deal with military trade management as a component of presumably overall competitive civilian trade.

The OMB summary places U.S. military trade into the context of overall U.S. international trade, and it into the context of standard economics.

Free Trade

The theory of free trade as originally developed by Adam Smith in the Eighteenth Century and as refined innumerably since, has become a keystone of U.S. economic policy. Unfortunately, there is growing recognition that this theory has serious problems. As noted in Part I, indirect trade management, through fiscal and monetary policy and the control of exchange rates is a basic part of government and cannot be avoided.

Direct management through tariffs, quotas, export zones, offsets, and the value added tax is a fact of life. Canada, Korea, Taiwan and Singapore control their exchange rates so that no matter how "competitive" American industry is, U.S. trade will always have a deficit with these nations.[3] In the case of Canada, the proposed U.S.-Canadian free trade treaty can only further disadvantage the U.S., since the matter of currency exchange rates is not addressed.

Korea, Taiwan, and Mexico use export zones as a means of manipulating their trade.[10] In export zones, raw materials and components may be imported without duties assessed, or may be manufactured locally. The end product is then manufactured, using the cheap local labor, often $2.00 - $4.00 per day or less. The only condition is that all products of the export zone must be exported. These nations are in essence exporting their cheap labor in exchange for the jobs created.

The Value Added Tax:

The value added tax (VAT) is the most subtle means of managing trade, but is also the most destructive in terms of U.S. exports. A full discussion of how it operates is beyond the scope of this article, but is available elsewhere.[1,5] Most European nations have such taxes. Canada has a producer's tax and Japan a commodity tax which operate in much the same manner as the VAT. The VAT is charged against domestic sales, but is rebated to manufacturers when goods are exported. The VAT is also imposed on imports. Thus, it acts to subsidize exports and penalize imports. When two nations have VATs they tend to offset each other in trade. However the United States, having no VAT, suffers when British and German cars enter the U.S., the VAT having been rebated, and with only minimal U.S. duties. Meanwhile, the 25 percent and 13 percent VAT is placed on American cars in the United Kingdom and Germany, respectively. This is not to advocate an American VAT. A VAT is a disguised sales tax, imposing its burden chiefly on the poor and middle classes.

American industry is faced with a host of obstacles to "free trade." Because monetary, fiscal, and exchange rate policies must be managed, managed trade is a fact of life. For the United States, the issue is how to best manage its overall trade, and how to best manage military trade as a component of its overall trade. Perhaps the President's Commission on Industrial Competitiveness should broaden its understanding of competitiveness to cover some of the issues addressed here.

The Variable Compensating Tax:

A variable compensating tax (VCT) has been proposed to deal with many of the trade management issues now being handled piecemeal.[1] It would work as described below.

All existing duties except those involving health and safety would be repealed. In their place a duty would be imposed on all products of nations with which the U.S. is in a cumulative trade deficit. Each year that the cumulative U.S. deficit was 5 percent or more of the 5 year cumulative average exports, the duty would be raised by 5 percent against all nations with which the U.S. was in cumulative deficit. If the cumulative surplus was 5 percent or more of the 5 year cumulative average exports, the duty against nations yielding the cumulative surplus, would be lowered by 2 percent. The VCT acts as a cybernetic feedback control. The feedback mechanism attains, then maintains the trade balance. Because U.S. trade is now so far out of kilter, a tax of 20-25 percent against nations now running 5 year average surpluses would be implemented to initialize the system.

Our trading partners manage trade through a host of means. Regardless of those means--export zones, tariffs, the VAT, or exchange rate control--the variable compensating tax would counterbalance them. Furthermore, it would bring in billions in duties, helping the United States balance its budget deficit. Note that our trading partners could not retaliate against the VCT. Retaliation would be self-defeating. However, the more they bought from us, the more they could sell.

Military Trade Under the VCT

The VCT helps solve many of the dilemmas of military trade. The size of the offset would be irrelevant. The VCT would assure that overall trade remained in balance.

Burden Sharing

If our allies failed to contribute their fair share of the defense burden, the billions flowing into the U.S. Treasury from the VCT would provide substantial compensation.

The Buying of America

Not mentioned by the OMB or ALESA is the growth in the purchase of American companies and real estate by foreigners, including some which are partially or wholly owned by foreign governments.[12] This is a growing concern of the Department of Defense.[6] These foreign companies are fat with profits based on their American sales, and are in a position to buy up large pieces of the U.S.A. It is only now becoming clear that the real cost of the trade deficit has been not only jobs, but loss of ownership of American industry itself.

Congress and the Department of Defense will have to deal with the existing situation. However, the VCT if implemented will, in the future, funnel the excess dollars from the foreign companies into the U.S. Treasury, in effect eliminating the problem.

Technology Transfer

Because the overall balance of trade and the balance of payments would no longer be issues in offsets if the VCT were implemented, the only relevant question would then be, do we want to give the technology to our friends, understanding that (1) it may be used to help them keep their technology up to date, (2) it does accelerate the introduction of competition to our own industry, both civilian and military, and (3) it does increase exposure to unauthorized disclosure.

No Panacea

The VCT is no panacea. The U.S. total trade deficit accumulated since 1980 is nearing $1 trillion. However, managing trade with the VCT, using accumulated balances as a guiding mechanism, would be a big step forward.

PART IV- CONCLUSION

The OMB analysis of offsets is essentially neutral, being more descriptive than prescriptive. However, by couching the discussion in conventional terms, the complexities obliterate the important issues.

The President's Commission on Industrial Competitiveness, by failing to deal with the full range of issues in defining competitiveness, inhibits discussion of critical issues. The OMB deals with the issues but attempts to do so within the confines of the restrictive definition. Until competitivity is considered in all aspects, including tax policies, exchange rates, trade balances, etc., key issues will only be skirted.

The ALESA testimony highlights the current rationale for permitting offsets under existing conditions. It is one-sided in favor of them.

Once it is understood that managing trade, both civilian and military, is unavoidable, the VCT presents a new method of considering the issues. The key to the variable compensating tax is that it presents a systematic way for the United States to respond to imbalances of trade, by nation and overall total. It would help balance the U.S. budget through the revenue it would generate, and cause our allies to indirectly contribute more to the common defense. Using the same approach, the trade balances would be used to determine who would and who would not be eligible for offsets.

The general approach involves the use of trade data as an input to an economic feedback control system. Because of the feedback feature, retaliation would be self-defeating. In any case, our trading partners have no justification to retaliate in the face of their enormous surpluses. The

VCT acts as an economic feedback control system. Decisions on technology transfer could be made on their merits alone.

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